DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 05-0237
INDIANA CORPORATE INCOME TAX
For the Years 1998 through 2000

NOTICE: Under IC § 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of the document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUE

I. **Reallocation of Taxpayer's Sales Income to Indiana** – Throw-back Sales.

Authority: 45 IAC 3.1-1-53(5); 45 IAC 3.1-1-64; IC § 6-3-1-25; IC § 6-3-2-2(e); IC § 6-3-2-2(n); IC § 6-3-2-2(n)(1); IC § 6-8.2-5-1(b); *Indiana Dept. of State Revenue v. Continental Steel Corp.*, 399 N.E.2d 754 (Ind. Ct. App. 1980); *Wisconsin Dept. of Revenue v. William Wrigley, Jr., Co.*, 112 S.Ct. 2447 (1992); PL 86-272 (15 U.S.C.S. § 381).

Taxpayer has protested the auditor's determination that certain of its sales – resulting from shipments from the taxpayer's plants inside Indiana but delivered to customers within other foreign states – should be included in the Indiana throw-back calculation. Taxpayer argues that because it is subject to a state income tax in those foreign states, sales to customers within those other states should not be included in the throw-back calculation.

.II. **Negligence Penalty**.

Authority: IC § 6-8.1-10-2.1; IC § 6-8.1-10-2.1(d); 45 IAC 15-11-2(b); 45 IAC 15-11-2(c).

Taxpayer argues that the assessment of the ten percent negligence penalty is unwarranted and should be abated.

STATEMENT OF FACTS

Taxpayer is a publicly held Indiana company which builds recreational vehicles and modular buildings. Taxpayer manufactures, markets, and distributes recreational vehicles and trailers. Taxpayer designs, manufactures, markets, and distributes modular homes.

Taxpayer is the parent company for twenty-three subsidiaries. Taxpayer files an Indiana combined return for the entire affiliated group reporting on a unitary basis.

The Indiana Department of Revenue (Department) conducted an audit review of taxpayer's business records and tax returns for the years 1994 through 2000. In addition to various other

adjustments, the audit determined that certain of taxpayer's 1998 through 2000 sales to customers located in the other states were subject to the throwback rule.

On the ground that it was subject to the other states' net income tax, taxpayer submitted a protest. A hearing was conducted during which taxpayer's representatives explained the basis for its protest. This Letter of Findings results.

I. Reallocation of Taxpayer's Sales Income to Indiana – Throw-back Sales.

DISCUSSION

Taxpayer challenges the audit's determination requiring the throwback of sales to destination states on the ground that taxpayer is subject to a net income tax in those other, destination states. The audit report took the stance that – for the purposes of determining the taxpayer's corporate income tax liability – certain sales to out-of-state customers should be allocated back to Indiana because the sales were to customers located within the other states where the taxpayer was *not* subject to a state net income tax.

Pursuant to 45 IAC 3.1-1-53(5), "[I]f the taxpayer is not taxable in the state of the purchase, the sale is attributed to [Indiana] if the property is shipped from an office, store, warehouse, factory, or other place of storage in this state." 45 IAC 3.1-1-64 defines what it means to be "taxable in the state of purchase." The regulation states that, "A corporation is 'taxable in another state' . . . when such state has jurisdiction to subject [the taxpayer] to a net income tax." Id. According to the audit report, "The audit has examined the taxpayer's activities in all states where shipments were indicated on their sales reports. From this examination determinations were made on which states the taxpayer is not subject to a net income tax and therefore subject to the throwback regulation."

IC § 6-3-2-2(e) provides that "[s]ales of tangible personal property are in this state if . . . (2) the property is shipped from an office, a store, a warehouse, a factory or other place of storage in this state . . . (B) the taxpayer is not taxable in the state of the purchaser."
IC § 6-3-2-2(n) provides that

> [f]or purposes of allocation and apportionment of income . . . a taxpayer is taxable in another state if: (1) in that state the taxpayer is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business or a corporate stock tax; or (2) that state has jurisdiction to subject the taxpayer to a net income tax regardless of whether, in fact, the state does or does not.

Therefore, in order to allocate income to a destination state – and take the income out of Indiana's reach – taxpayer must show that one of the taxes listed in IC § 6-3-2-2(n)(1) has been levied against him or that the destination state has the jurisdiction to impose a net income tax regardless of whether that state actually does so.

For the purposes of determining whether a taxpayer is subject to the taxing jurisdiction of another state pursuant to 45 IAC 3.1-1-64, "[t]he term 'state' means any state of the United

States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States, and any foreign country or political subdivision thereof." IC § 6-3-1-25. Accordingly, Canada falls within the definition of a "state" and income received from selling to customers within Canada is potentially subject to the throw-back rule..

The issue becomes whether or not the target state is entitled to tax income received by an Indiana taxpayer but derived from the target state's customers. 15 U.S.C.S. § 381 (Public Law 86-272) controls those occasions in which a state may properly impose a tax on the net income, derived from sources within that state, by out-of-state taxpayers. 15 U.S.C.S. § 381 establishes the minimum standard for the imposition of a state income tax based on the solicitation of interstate sales. *Wisconsin Dept. of Revenue v. William Wrigley, Jr., Co.*, 112 S. Ct. 2447, 2453 (1992). 15 U.S.C.S. § 381 prohibits a state form imposing a net income tax on a out-of-state taxpayer if the out-of-state taxpayer's only business activity within that state is the solicitation of sales. A state may not impose an income tax on income derived from business activities with that state unless those business activities exceed the *mere solicitation* of sales. 15 U.S.C.S. 381(a), (c). Conversely, the effect of the throw-back rule is to revert sales receipts back to the state – in this case Indiana – from where the goods were shipped in those situations where 15 U.S.C.S. § 381 deprives the purchaser's own state of the power to impose a net income tax. 45 IAC 3.1-1-64. In effect, 15 U.S.C.S. § 381 permits Indiana to tax out-of-state business activities – without violating the Commerce Clause and without the possibility of subjecting the Indiana taxpayer to double taxation – because Indiana's right to tax those out-of-state activities is derivative of the foreign state's own taxing authority. In every transaction, at least one state has the authority to tax income derived from the sale of tangible personal property; if the state wherein the sale occurred is forbidden to do so by 15 U.S.C.S. § 381, then the income is "thrown-back" to the originating state.

In *Indiana Dept. of State Revenue v. Continental Steel Corp*., 399 N.E.2d 754 (Ind. Ct. App. 1980), the court set out a definition of what does and what does not exceed the 15 U.S.C.S. § 381 "mere solicitation" standard. The court held that, "solicitation should be limited to those generally accepted or customary acts in the industry which lead to the placing of orders, not those which follow as a natural result of the transaction, such as collections, servicing complaints, technical assistance and training . . ." Id. at 759. Further, "solicitation must be limited to those acts which lead to the placing of orders and does not include those acts which follow as a result of the transaction." Id. The court gave examples of activity which exceeded the "mere solicitation" standard including "giving spot credit, accepting orders, collecting delinquent accounts and picking up returned goods within the taxing state, collecting deposits and advances on orders within the taxing state, pooling and exchanging technical personnel in a complex mutual endeavor, maintaining personal property [] and associated local business activity for purposes not related to soliciting orders within the taxing state." Id.

The "mere solicitation" standard was refined by the Supreme Court in *Wisconsin Dept. of Revenue v. William Wrigley, Jr., Co.*, 112 S.Ct. 2447 (1992). The Court concluded that "although solicitation covered more than what was strictly essential to making requests for purchases, the fact that an activity is performed by salespersons does not automatically convert that activity into solicitation." Id. at 2456-57. The Court held that whether the taxpayer's in-state activity was sufficiently de minimis to avoid the loss of taxpayer immunity, conferred by 15 U.S.C.S. § 381,

depended on whether the activity establishes a "non-trivial additional connection with the taxing State." Id. at 2458. In *Wrigley*, the Court determined that the taxpayer's sales representatives' activities, consisting of replacing stale gum at retail locations, was an activity outside 15 U.S.C.S. § 381 immunity. Id. at 2458-59. The Court held that although the representatives' activity could be said to facilitate the sales, it did not facilitate the *requesting* of sales and was not ancillary to the solicitation of sales. Id. at 2459 (*Emphasis added*). Therefore, because taxpayer's practice of having its representatives rotate stocks of stale gum was an activity outside the solicitation of sales, taxpayer brought itself outside the scope of 15 U.S.C.S. § 381 immunity and subjected itself to the local net income tax. Id. at 2460.

A. First-Tier States: Taxpayer has stated that its local activities exceeds the protection of P.L. 86-272 in Massachusetts, Mississippi, Nebraska, Nevada, New York, Oklahoma, South Dakota, Vermont, and Wyoming.

Taxpayer claims that it engages in certain non-exempt activities in these nine, first-tier states; taxpayer concludes that these activities bring it within the orbit of the first-tier states' taxing jurisdiction. Taxpayer states that it rents cranes in these states to help assemble their modular homes; taxpayer states that it sends in its own employees to "rough set" and "waterproof" the modular homes. Taxpayer states that it sends employees into these states to repair modular homes. In addition, taxpayer states that its employees pick up damaged products in these states and that it hires agents to provide warranty services.

B. Second-Tier States: Taxpayer has stated that its activities its activities in certain other jurisdictions also exceeds the protection of P.L. 86-272; this second-tier of states includes Washington, Alaska, Arizona, Colorado, Idaho, Maine, Montana, North Dakota, New Mexico, Oregon, Rhode Island, and Utah. Within this second-tier of states, taxpayer claims that its employees pick up damaged products and that its agents provide warranty services. For purposes of this discussion, Canada is categorized as one of the second-tier jurisdictions. Therefore, the second-tier of states consists of thirteen taxing jurisdictions.

When a taxpayer challenges a tax assessment, it is up to the taxpayer to demonstrate that the assessment is incorrect. "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." IC § 6-8.1-5-1(b). Taxpayer has provided the following information in support of its position that the sales to both the first and second-tier states – all twenty-two taxing jurisdictions – should not be "thrown back" to Indiana.

Included among that information is a redacted letter dated June 1, 2006, outlining the responsibilities of prospective Regional Sales Managers. Taxpayer states that this draft letter "clearly describes the duties of a District Manager to include retail sales training, and consultative selling strategies."

Taxpayer has provided copies of expense reports indicating that taxpayer's representatives visited dealer locations in Ohio, Maryland, Pennsylvania, Kansas, Michigan, New Jersey, Mississippi, Idaho, Washington, Idaho, Maine, New Mexico, Utah, Arizona, and Colorado.

In addition, taxpayer has provided an affidavit prepared by its vice president who states that he has "personal knowledge" of "sales activities relative to recreational vehicle[s]." The vice president states in the affidavit that taxpayer's "sales personnel provide training to customers' sales staffs, advise the customer on product merchandising issues, consults with the customer on inventory levels, and advise the customer of best sales practices to assist the dealer in running a successful dealership."

The Department is unable to conclude that taxpayer has met its "burden of proving that the proposed assessment is wrong . . . ." IC § 6-8.1-5-1(b). The information provided by taxpayer lacks substantiation or is conclusory. For example, taxpayer asserts that it rents cranes in the first-tier destination states in order to "rough set its modular homes," but taxpayer has provided no substantive information to support this assertion; taxpayer has provided no contracts, logs, expense reports, or detailed information as to the number of occasions it rented cranes. Did taxpayer rent cranes in two states on four occasions or did taxpayer rent one-hundred cranes on one-hundred occasions in each of the twenty-two jurisdictions? Similarly, taxpayer has provided nothing to substantiate its claim that it sends its own employees into the first-tier states to "rough set," waterproof, or repair its modular homes. Did taxpayer send its employees to out-of-state locations on four occasions or four-hundred occasions? Taxpayer has provided nothing to explain in what manner or with what frequency its employees retrieve damaged goods from the first-tier states; taxpayer has provided nothing to explain or establish in what manner or with what frequency it sends agents into the first-tier states to perform warranty work on its modular homes. Did taxpayer hire agents to perform warranty services in one state or all twenty-two jurisdictions? Did its agents spend ten hours performing warranty service or 10,000 hours? Taxpayer has made broad-brush stroke, conclusory assertions, but has provided little to substantiate its conclusion that the sales to the first-tier states should not be thrown back to Indiana because its activities within the first tier state exceeded the protection afforded by Public Law 86-272.

In the case of the second-tier states, taxpayer has provided documentary evidence indicating that it sends representatives to local dealers to encourage the dealers to sell more of taxpayer's products. Setting the questions concerning the sufficiency of this documentary evidence, the activities delineated within the documents suggest that the activities described are related to – if but one step removed from – taxpayer's and local dealers' efforts to encourage the purchase of modular homes and recreational vehicles. The activities set out in the documents would appear simply to be "those generally accepted or customary acts in the industry which lead to the placing of orders . . . ." *Continental Steel Corp.*, 399 N.E.2d 759. Taxpayer has failed to establish that the activities with the second-tier jurisdictions constitute a "non-trivial additional connection with the taxing State." *Wrigley*, 112 S.Ct. 2458.

In its initial protest letter, taxpayer correctly pointed out that, "The Department cannot require sales to be thrown back to Indiana if the sales made to a state that has jurisdiction to subject [taxpayer] to a net income tax *regardless of whether, in fact, the state does or does not*." Nonetheless, although not conclusive on the issue, the Department finds telling the fact that taxpayer did not provide adequate information establishing that it was – in fact – subject to the foreign states' income tax. Taxpayer did not submit copies of state income tax returns for any of

the twenty-two destination state jurisdictions during the periods at issue. Taxpayer's argument is that the sales should not have been thrown back to Indiana because its out-of-state activities brought it within the orbit of twenty-two destination state taxing jurisdictions. Taxpayer failed to provide adequate information to definitively establish that this was in fact the case.

FINDING

Taxpayer's protest is respectfully denied.

II. Negligence Penalty.

DISCUSSION

Taxpayer argues that it is entitled to an abatement of the ten-percent negligence penalty. IC § 6-8.1-10-2.1 requires that a ten-percent penalty be imposed if the tax deficiency results from the taxpayer's negligence. Departmental regulation 45 IAC 15-11-2(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is to "be determined on a case-by-case basis according to the facts and circumstances of each taxpayer." Id.

IC § 6-8.1-10-2.1(d) allows the Department to waive the penalty upon a showing that the failure to pay the deficiency was based on "reasonable cause and not due to willful neglect." Departmental regulation 45 IAC 15-11-2(c) requires that in order to establish "reasonable cause," the taxpayer must demonstrate that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed . . . ."

Although disagreeing as to the applicability of the throw-back rule, the Department agrees that there is little in the record to establish that the additional assessment was attributable to the taxpayer's failure to use such reasonable care as would be expected of an ordinary, reasonable taxpayer.

FINDING

Taxpayer's protest is sustained.

DK/DP/BK – October 6, 2006.